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FY 1987 OUTLOOK FOR THE JAPANESE ECONOMY

Summary

Japan's economic expansion, which began in March 1983, ended in the first quarter of 1986 with a 1.7 percent contraction. Its industrial sector has been shocked by the appreciation of the yen; Nippon Steel Corp. has announced layoffs, Nissan Motor Co., Ltd. has suffered its first operating loss, and Japan's oldest coal mine is slated to close. Mining and manufacturing production declined last year for the first time in 11 years. The loss of jobs in the manufacturing sector has made unemployment a major issue for the first time. Private-sector economists expect inflation-adjusted growth to fall to about 2 percent in FY 1986 (April 1, 1986-March 31, 1987), the lowest since the 1973-74 oil shock.

The government's FY 1987 outlook projects a strong rise in domestic demand that will offset falling net exports and boost gross national product by 3.5 percent in real terms. The deflationary effect of the strong yen on export-oriented industries, though, is likely to spread to other sectors and keep growth in the 2 to 3 percent range. External demand will have a negative impact for the second consecutive year. One positive note is the expected decline in Japan's large current account surplus.

Domestic Demand Versus External Demand

Japan's economy in 1986 was hard-hit by the 65 percent appreciation of the yen that began in February 1985. Exports declined in terms of volume and

yen value (see Table 1), exerting a drag on the economy for the first time in eight years. The government estimates FY 1986 real growth at 3 percent, the lowest postwar level since fiscal 1974's negative rate after the first oil shock. The rise of the yen has meant the worst of both worlds; falling net external demand is slowing the economy at the same time Japan's trade surplus in dollar terms is hitting record levels, exacerbating tensions with the country's trading partners. The trade surplus is expected to rise from $61.6 billion in FY 1985 to $94 billion in the current fiscal year, as currency changes outweigh volume changes (the J-curve effect).

Table 1: Exports and Imports, 1986

(percent change from year-earlier levels)

	January-March	April-June	July-September	October-December*	Year*
Exports					
Volume	-0.1%	-0.8%	-0.2%	-4.2%	-1.4%
Yen value	-12.3	-17.3	-18.5	-15.2	-15.9
Dollar value	18.2	21.6	24.8	12.5	19.1
Imports					
Volume	3.7	16.8	18.8	14.3	13.3
Yen value	-23.9	-33.2	-36.8	-29.0	-30.6
Dollar value	1.7	-1.9	-3.4	-5.6	-2.3

*Preliminary

Source: Japan Tariff Association

The appreciation of the yen was a serious blow to the expansion that began in March 1983. Net exports accounted directly for 24 percent of growth in the 1984-85 period, in addition to fueling a double-digit increase in business investment. In contrast, domestic spending in real terms grew sluggishly at about 2.5 percent. The challenge in fiscal 1987 (April 1, 1987-March 31, 1988) will be to achieve sufficient domestic demand to offset declining net exports.

Although Japan's economy is often described as export-dependent, domestic demand actually played a more important role until recently. During the 1970s, a contraction in external demand slowed growth in four years and the current account surplus averaged only $2.5 billion (see Table 2). Japan's large trade surpluses in the 1980s reflect several factors, including less expensive oil and raw material imports. At the same time, the rise in the dollar, primarily a result of the large U.S. budget deficit, has encouraged a surge in exports to the United States.

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Table 2: Components of Japan's Real Economic Growth

	Total Rate	Domestic Component	External Component	Current Account Surplus*
FY 1970	8.3%	8.9%	-0.7%	$2.3
FY 1971	5.3	4.0	1.3	6.3
FY 1972	9.7	10.6	-0.8	6.2
FY 1973	5.3	7.5	-2.2	-3.9
FY 1974	-0.2	-2.8	2.6	-2.3
FY 1975	3.6	2.0	1.6	0.1
FY 1976	5.1	3.6	1.5	4.7
FY 1977	5.3	4.2	1.0	14.0
FY 1978	5.1	6.9	-1.8	11.9
FY 1979	5.3	4.8	0.5	-13.9
FY 1980	4.0	1.0	3.0	-7.0
FY 1981	3.3	2.1	1.2	5.9
FY 1982	3.2	2.7	0.5	9.1
FY 1983	3.7	2.1	1.5	24.2
FY 1984	5.1	3.8	1.2	37.0
FY 1985	4.3	3.6	0.7	55.0
FY 1986**	3.0	4.4	-1.4	88.0
FY 1987***	3.5	4.0	-0.5	77.0

*In billions of dollars.
**Calculated from government's real growth estimate of 3 percent.
***Government outlook.

Source: Economic Planning Agency

Government's Economic Outlook

Despite the adverse effects of the strong yen, the Japanese government's economic outlook, adopted by the cabinet December 24, forecasts 3.5 percent real growth in FY 1987 (see Table 3). Finance Minister Kiichi Miyazawa has predicted that the economy will bottom out in the latter half of calendar 1987 if effective government policies are pursued. Economic officials believe moderately high domestic growth is essential to reduce the country's trade surplus and prevent a rise in unemployment. Tokyo is counting on domestic demand to boost the economy by 4 percent to offset the external sector's 0.5 percent negative impact. The demand will have to come mainly from the private sector, as government spending is scheduled to rise only 1.1 percent in real terms and is expected to account for only 0.2 percentage point of growth.

A further rise in the yen, however, could scuttle the government's optimistic scenario. The rise beyond the Y204=$1.00 rate assumed in the government's initial FY 1986 outlook, for example, made 4 percent real growth unattainable. While the outlook for the coming fiscal year assumes an exchange rate of Y163=$1.00, the surge above the 150 yen level on January 19 created considerable uncertainty. The Bank of Japan, which views exchange rate stability as the key to economic recovery, has promised to do everything possible to stabilize the yen. There is likely to be continued downward pressure on the dollar, however, until the U.S. trade deficit begins to fall and the American economy shows more strength.

Table 3: Japanese Government's FY 1987 Forecast

	Actual			Estimated	Projected
	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987
Real Gross National Product	3.7%	5.1%	4.3%	3.0%	3.5%
Consumer Spending	3.0	2.6	2.6	3.7	3.4
Residential Construction	-8.9	0.5	2.9	12.7	7.1
Private Capital Spending	4.9	11.4	12.9	5.2	6.6
Government Expenditures	1.2	0.8	-1.6	5.5	1.1
Exports	8.7	15.5	1.8	-3.0	-0.7
Imports	-0.5	9.8	-2.4	4.9	2.4
Current Account Surplus*	$24.2	$37.0	$55.0	$88.0	$77.0
Trade Surplus*	$34.5	$45.6	$61.6	$94.0	$81.0
Wholesale Prices	-2.3	0.2	-2.9	-9.7	1.0
Consumer Prices	1.9	2.2	1.9	0.5	1.6

*In billions of dollars.

Private-sector growth forecasts average only 2.1 percent for FY 1986 (see Table 4), which will be substantially below the 3.8 percent and 2.6 percent rates achieved in the first two quarters (see Table 5). Even if the economy accelerates modestly in fiscal 1987, the consensus is that growth will only reach 2.4 percent. This slow-growth forecast reflects doubts that the vibrant nonmanufacturing sector is strong enough to lift the economy out of the "strong-yen recession." It is more likely, many analysts argue, that the slump in the manufacturing sector will spill over to the nonmanufacturing sector.

External Demand

Projections of Japan's net foreign demand depend heavily on the U.S. economy, which absorbed nearly 40 percent of Japanese exports in 1986. The U.S. economic recovery, now over 50 months old, will become the longest peacetime expansion in the postwar era if it continues through October 1987. While business cycles do not die of old age, the extended expansion has now satisfied the backlog of consumption and investment demand that accumulated during the stagflation of the 1970s and the 1981-82 recession. But the real income gains that have fueled consumer spending and sustained the expansion through 1986 could be threatened by higher inflation. Consumer prices rose only 1.9 percent last year because of the collapse of oil prices. By the end of 1986, however, inflation was back in the 3 percent range, and the administration forecasts a 3.8 percent rise in 1987.

The large decline in the dollar's value over the past two years, though, should be a positive factor for the U.S. economy. A modest improvement in exports and the diversion of demand to domestic sources will probably lower the U.S. trade deficit by $20 to $40 billion, adding 0.5 to 1 percentage point to growth. The improvement in the trade position should sustain the current expansion through 1987 at the moderate 2.5 to 3 percent pace that has prevailed since mid-1984, despite slowing domestic demand. It follows that the increase in total U.S. imports will be below 1986's 9.8 percent gain.

Table 4: Summary of Private Forecasts

(percent change in real terms)

	GNP FY 1986	GNP FY 1987	Current Account Surplus*	Y/$ Exchange Rate	Oil Price ($/barrel)
Banks					
Hokkaido Takushoku Bank	1.8%	2.1%	$74.3	Y170.5	$15.1
Fuji Bank	2.0	1.7	70.0	161.0	17.5
Taiyo Kobe Bank	2.0	2.5	84.6	162.5	14.5
Sumitomo Trust	2.1	3.0	76.8	160.0	15.1
Mitsubishi Trust	2.1	2.4	75.7	157.0	15.6
Bank of Yokohama	2.1	1.9	65.6	160.0	15.0
Dai-Ichi Kangyo Bank	2.2	2.6	88.5	150.0	15.0
Nippon Credit Bank	2.2	2.7	72.5	157.5	16.5
Yasuda Trust	2.2	1.9	86.1	160.0	15.5
Bank of Tokyo	2.3	2.7	72.2	153.5	15.6
Mitsui Trust	2.3	1.9	70.4	154.3	15.0
Tokai Bank	2.4	1.6	80.0	150.0	15.0
Insurance Companies					
Asahi Mutual Life	1.9	2.6	96.5	159.0	15.5
Tokio Marine	2.1	2.5	71.2	163.0	15.6
Meiji Mutual Life	2.3	2.4	75.6	157.5	15.0
Nippon Life	2.4	2.3	88.0	160.0	17.0
Research Organizations					
Mitsubishi Research Institute	1.9	1.8	86.8	163.0	16.0
Okasan Economic Research Institute	2.1	2.3	87.1	152.5	15.0
Kangyo Kakumaru Research Institute	2.1	3.0	82.6	165.0	16.0
Nomura Research Institute	2.2	2.3	73.5	152.0	13.0
Cosmo Research Center	2.3	2.7	73.9	160.0	14.8
Japan Economic Research Center	2.3	3.1	85.7	151.3	15.9
Nikko Research Center	2.4	2.7	73.9	161.5	16.0
Sanwa Research Institute	2.5	2.5	73.1	158.0	15.0
Research Institue of the National Economy	2.5	3.5	81.3	155.0	14.8
Average Forecast	2.1	2.4	78.6	158.1	15.4

*In billions of dollars.

Table 5: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1985	October-December 1985	January-March 1986	April-June 1986	July-September 1986
Gross national product	Y293,332.7	Y295,760.3	Y294,483.4	Y297,230.1	Y299,128.5
	(4.3%)	(4.7%)	(-1.7%)	(3.8%)	(2.6%)
Personal consumption spending	162,999.0	163,477.4	164,123.7	166,134.2	168,252.2
	(2.6%)	(2.1%)	(1.6%)	(5.0%)	(5.2%)
Private residential construction	14,107.9	14,124.4	14,340.6	14,808.5	15,857.2
	(2.9%)	(6.8%)	(6.3%)	(13.7%)	(31.5%)
Private fixed nonresidential investment	53,760.3	54,811.3	54,983.4	55,204.3	55,469.9
	(12.9%)	(10.8%)	(1.3%)	(1.6%)	(1.9%)
Change in business inventories	2,016.2	2,172.1	1,726.5	639.5	809.4
	(8.7%)	(77.0%)	(-60.0%)	(-98.1%)	(156.6%)
Government current expenditures	27,240.9	27,370.1	27,606.7	27,719.2	28,015.3
	(1.9%)	(3.9%)	(3.5%)	(1.6%)	(4.3%)
Government fixed investment	20,772.5	20,960.5	21,022.4	21,785.4	22,144.6
	(-6.4%)	(7.1%)	(1.2%)	(15.3%)	(6.8%)
Change in government inventories	297.9	608.7	39.6	3,251.8	1,795.1
	(*)	(*)	(*)	(*)	(*)
Net external sector	12,138.1	12,235.9	10,840.6	7,687.2	6,784.8
	(19.9%)	(-4.7%)	(-42.8%)	(-72.8%)	(-39.3%)
Exports of goods and services and factor income received	54,496.6	53,973.3	52,208.9	53,044.1	52,497.7
	(1.8%)	(-7.1%)	(-12.4%)	(6.6%)	(-4.1%)
Imports of goods and services and factor income paid	42,358.6	41,737.5	41,568.3	45,356.9	45,712.9
	(-2.4%)	(-7.8%)	(-1.6%)	(41.8%)	(3.2%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

With only a modest rise in U.S. demand for imports and growing trade friction with the European Community, the slump in Japanese exports is likely to continue. Government officials expect a 0.7 percent decline in constant-price yen terms in FY 1987, while the Bank of Tokyo forecasts a 4.8 percent drop in volume. Meanwhile, the strong yen should spur demand for manufactured imports, which accounted for close to 35 percent of 1986 deliveries from abroad. The Bank of Tokyo is projecting a 4 percent rise in import volume on top of FY 1986's expected 18.6 percent rise.

Although it will have a deflationary effect on the economy, the changes in trade volume should finally begin to decrease Japan's current account balance in FY 1987 after seven consecutive annual increases. The rise in the dollar value of Japan's exports finally slowed in the last three months of 1986, indicating that the J-curve effect has already peaked. Tokyo expects a $77 billion current account surplus in FY 1987, which would be equivalent to about 3.6 percent of nominal GNP, down from an estimated 4.3 percent in fiscal 1986.

Domestic Private Demand

Domestic demand will be influenced by the first major overhaul of the tax system in 37 years. The proposed tax reform plan, which is expected to be approved by the Diet this spring, was influenced by last year's changes in U.S. tax law. Japan's 15 individual tax brackets will be reduced to 13 this year and 6 in 1988 and marginal rates will be lowered (see JEI Report No. 1B, January 9, 1987). Corporate taxes, which currently are among the highest in the industrialized world, will also be reduced. The lost revenue, estimated at Y4.5 trillion ($30 billion at Y150=$1.00) over the FY 1987-89 period, will be offset in part by a 5 percent sales tax scheduled to go into effect in January 1988.

Although the tax reform is revenue neutral on paper in both FY 1987 and FY 1988, Tokyo hopes that the supply-side incentives will produce greater economic dynamism and eventually help reduce the budget deficit. The current system, which depends primarily on income taxes, was effective when income was growing rapidly, but a sales tax provides a larger and more reliable source of revenue. Moreover, it can be raised, as it has been in Europe, to provide more revenue. However, the proposed tax is politically unpopular and faces determined opposition in the Diet, where even some members of the LDP are said to be against it. Some tax analysts fear that the 5 percent levy will discourage spending at a time when Japan needs to stimulate domestic demand. Its effect, though, may be offset by the abolition of the tax exemption on interest income earned on postal savings and bank accounts of up to Y3 million ($20,000). Beginning October 1, 1987, this income will be subject to a 20 percent withholding tax -- a measure designed to discourage saving.

Since the tax reform is intended to be revenue neutral, its overall macroeconomic effect should be small in FY 1987. According to Nihon Keizai Shimbun's model of the Japanese economy, it will raise consumer prices by 0.4 percent, slowing real consumer spending by 0.1 percent. Tax reform, though, is likely to affect the timing of purchases of major consumer items and capital investment goods. With the sales tax scheduled for introduction in January 1988, there should be a surge in sales in the second half of 1987, weakening demand in the first part of 1988.

Personal Consumption Spending - Personal consumption, which accounts for more than half of Japan's GNP, grew at a robust 5 percent inflation-adjusted pace during the first half of fiscal 1986. The government's economic outlook projects a gain of 3.7 percent in the current fiscal year and 3.4 percent in FY 1987.

Increases in consumer outlays, of course, depend on real income gains. Some labor leaders have called for wage hikes equal to the average 4.5 percent won last year to give domestic demand a major boost. But the Japan Federation of Employers' Associations (Nikkeiren), anxious to hold the line on wage increases, says job security is a more important priority and warns workers not to expect raises this year. Higher labor costs, they argue, would weaken firms already hurt by the strong yen and encourage them to move production overseas.

Most analysts expect wage gains in the 2.5 to 3.5 percent range -- the smallest in 30 years. This is consistent with the government's economic outlook, which projects a 3 percent rise in per-capita employee income in FY 1987, down from an anticipated 3.2 percent this year. Income gains will be further diminished if consumer prices begin rising as forecast. The rise in the yen and the fall in oil prices resulted in a 7 percent fall in utility rates last June that will help limit the increase in consumer prices to about 0.5 percent in FY 1986. The government, though, expects prices to increase 1.6 percent in fiscal 1987, reducing real income gains to only 1.4 percent -- about half of this year's.

Further weakening consumer spending is the country's rising unemployment, an issue that has pushed its way to the top of the political agenda despite the fact that the rate is low compared to other nations. It is estimated, though, that the 2.8 percent unemployment rate reported for 1986 would be roughly twice as high if it were calculated according to the U.S. definition. Prime Minister Yasuhiro Nakasone acknowledged recently that preserving jobs is a major task for the government.

Although the government expects unemployment to remain at a record high level of 2.9 percent in FY 1987, many economists doubt that it can be kept below 3 percent. According to a Ministry of International Trade and Industry official, the economy would have to grow at a 3.9 percent real rate to prevent unemployment from increasing. The problem is of particular concern in the manufacturing sector. A December report by the Economic Planning Agency estimated that the manufacturing sector employed 300,000 redundant workers. Their dismissal alone would raise unemployment by 0.5 percentage point.

Private-sector forecasters, such as Sanwa Research Institute, predict that Japan's unemployment rate will rise as high as 3.5 percent by the end of fiscal 1987 as more and more firms decide to move production facilities out of Japan in order to remain competitive. Wages in Japan are six times higher than in South Korea and Taiwan. Mitsubishi Research Institute estimates that direct foreign investment will cost Japan 150,000 manufacturing jobs in 1987.

Private Plant and Equipment Investment - Corporate earnings and sales are down sharply in FY 1986. Yamaichi Research Institute is predicting that profits will fall 19.3 percent while sales drop 11.4 percent. There is a sharp contrast, though, between nonmanufacturing and manufacturing; the latter's profits are expected to fall as much as 32.3 percent, as exporters pass on only

about half of the yen's rise in export prices in an effort to maintain market share abroad.

The slump in earnings has helped slow the real increase in capital spending from its double-digit pace to an estimated 5.2 percent during the current fiscal year. Several factors, however, support the government's forecast that business investment will rise to 6.6 percent in fiscal 1987. The current record-low interest rates reduce borrowing costs and encourage investment. Last month, for example, the long-term prime rate was lowered to 5.8 percent, an all-time low. Moreover, corporate profits are expected to increase in fiscal 1987 by as much as 13.2 percent, according to Nomura Research Institute. Given their reluctance to raise export prices, manufacturers must reduce costs to maintain their earnings. Efforts to maintain competitiveness in the face of the strong yen should also encourage investment during the next several years.

Private Residential Construction - Increased investment in housing has received support, both in Japan and abroad, as a way of improving the standard of living while expanding domestic demand and reducing the trade surplus. Although housing construction accounts for less than 5 percent of GNP, it has a significant impact on the rate of growth. Housing investment is estimated to increase total production by 2.2 times the original investment compared to only 1.7 times for household consumption.

Encouraged by low interest rates and government incentives, housing starts in 1986 were expected to top 1.35 million, the highest since 1979. Despite rising land prices, the housing market should remain strong. The government economic outlook projects a 7.1 percent real rise in residential construction in FY 1987 on top of a 12.7 percent increase in the current fiscal year.

Government Economic Policies

Monetary policy was at the forefront of Tokyo's efforts to stimulate the economy in 1986. Money supply growth was steady in the 8 to 9 percent range (M2+CDs). The Bank of Japan's official discount rate, the fee charged on loans to financial institutions, was cut four times to a record low of 3 percent, resulting in a general decline in interest rates. The interest rate on ordinary deposits, for example, was cut to 0.26 percent last November. As a result, policy changes to stimulate the economy in the coming year will have to come primarily from the fiscal side.

The draft budget for FY 1987, which is likely to be adopted intact by the Diet, attempts to accommodate two contradictory demands. As part of the government's goal to end reliance on deficit-financing bonds, discretionary expenditures are to be cut for the fifth consecutive year (see JEI Report No. 1B, January 9, 1987). The general account budget (discretionary spending plus public debt service and transfers to local government) is slated to rise only 0.02 percent to Y54,101 billion ($360.7 billion), the smallest increase in 32 years. To expand domestic demand, spending under the Fiscal Investment and Loan Program is projected to increase 22.2 percent, resulting in an overall 5 percent rise in public works spending. (The so-called "second budget" is financed primarily by postal savings and public pension funds.)

Tokyo's spending restraint will allow it to reduce the ratio of government bond issues to total revenues to a projected 19.4 percent in FY 1987, the

first year since FY 1975 that the figure is expected to come in under 20 percent. It is unlikely, however, that the government will be able to stop issuing deficit-covering bonds by fiscal 1990. The scheduled Y265 billion ($1.8 billion) cut to Y4,981 billion ($33.2 billion) in FY 1987 is far less than the annual reduction necessary to reach the target.

Tokyo forecasts an inflation-adjusted 1.1 percent rise in government spending that will add 0.2 percentage point to economic growth. There has been some criticism, both at home and abroad, of the government's continued fiscal restraint in the face of the slowing economy. A Keidanren poll of business leaders taken in November reported that 64.8 percent favored fiscal policy action to revitalize the economy, while only 13.8 percent favored monetary policy adjustments. Already there are calls within the LDP for an early supplementary budget to boost the economy.

Tokyo's concern about budget deficits reflects the rising costs of servicing its public debt, which is equivalent to about 43 percent of GNP and will absorb 20.9 percent of expenditures in FY 1987 (compared to an estimated 13.5 percent in the United States). Tokyo is also concerned about the impact of its rapidly aging society. According to one study, if Japan continues its current fiscal policy with no changes in public pension policies, its public debt will exceed GNP in the year 2010. Mr. Nakasone told the Diet in December that the government's tight fiscal policy will continue. Efforts to stimulate the economy will attempt to utilize private-sector resources to implement public works projects.

Conclusion

Japan's real economic growth rate in FY 1987 should be about 2.5 percent, barring a further substantial rise in the yen. Growth will depend almost entirely on domestic private demand as the expansionary effect of fiscal policy will be minimal and declining net exports exert a substantial deflationary impact. Small wage increases, rising consumer prices and a deteriorating employment situation are likely to limit consumer spending and keep growth below the 3.5 percent government outlook.

The 1984-85 economic expansion was aided by a 23.7 percent rise in exports, about three-quarters of which was absorbed by the United States. With this country now the world's largest debtor nation, Japan can no longer rely on shipments to the United States to boost its economy. It faces structural adjustments that rival those following the oil shock. A recent survey of 400 major corporations reported that 64 percent believe it will take at least two years to adjust to the strong yen. With fiscal policy's role limited by the government's commitment to financial reconstruction, deregulation is essential to enable the private sector to make the best use of its resources.

For further information, contact Randall Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.